

I. CURRENT TECHNICAL ISSUES: ELECTRIC COOPERATIVES AND COOPERATIVE TELEPHONE COMPANIES DESCRIBED IN IRC 501(c)(12)

1. Introduction

The purpose of this article is to survey recent technical issues relating to electric cooperatives and cooperative telephone companies described in IRC 501(c)(12), but there will also be some discussion of other types of exempt cooperatives. This survey is necessitated by recent changes in the law and regulations regarding IRC 501(c)(12) as well as recent National Office consideration of novel issues pertaining to these types of exempt cooperatives.

This presentation begins by discussing general exemption requirements pertaining to cooperatives under IRC 501(c)(12), especially the cooperative characteristics that an organization must have in order to qualify for exemption. Recent changes in the statute and regulations with respect to the exemption of telephone cooperatives are also discussed. The article then goes on to examine issues under the unrelated business income tax provisions that may arise in connection with exempt cooperatives. Finally, recent legislative developments are reviewed. Benevolent life insurance companies are not considered in this article.

2. Basic Requirements for Recognition of Exemption

a. Code and Regulations

IRC 501(c)(12) provides for the recognition of exemption from federal income tax of benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses. In the case of any mutual or cooperative telephone company, the preceding sentence shall be applied without taking into account any income received or accrued from a nonmember telephone company for the performance of communication services which involve members of such mutual or cooperative telephone company.

Reg. 1.501(c)(12)-1(a) states in part that an organization may be entitled to exemption, if it makes advance assessments to meet future losses and expenses,

provided that the balance of such assessments remaining on hand at the end of the year is retained to meet losses and expenses or is returned to members.

Reg. 1.501(c)(12)-1(c) provides, in part, that for taxable years of a mutual or cooperative telephone company beginning after December 31, 1974, the 85 percent member-income test described in paragraph (a) is applied without taking into account income received or accrued from another telephone company for the performance of communication services.

b. General Discussion

Although electric cooperatives are not specifically mentioned in IRC 501(c)(12), it was held in Rev. Rul. 67-265, 1967-1 C.B. 205, that a cooperative organization furnishing heat and light to its members is a "like organization" within the meaning of the statute. The term "like organization," as used in the statute and interpreted by Rev. Rul. 65-201, 1965-2 C.B. 170, is applicable only to those mutual or cooperative organizations which are engaged in activities similar in nature to the benevolent insurance or public utility type of service or business customarily conducted by the organizations specified in IRC 501(c)(12). Two other significant words in the statute are "cooperative" and "mutual," but the Service has not made any distinction in these terms in its Revenue Rulings. Therefore, for the sake of clarity and uniformity, this presentation refers only to the term "cooperative."

For many years the Internal Revenue Service has issued individual rulings requiring an interpretation of the term "cooperative" as used in the statute. There is no definition of "cooperative" in IRC 501(c)(12) and the regulations thereunder, but cooperatives have a long history with well established principles. Three main cooperative principles were summarized by the Tax Court in Puget Sound Plywood, 44 T.C. 305 (1965), acq. 1966-1 C.B. 3:

(1) Subordination of capital both as regards to control of the cooperative undertaking and as regards to ownership of the pecuniary benefits arising therefrom; (2) democratic control by the worker-members themselves; and (3) the vesting in and allocation among the worker-members of all the fruits and increases arising from their cooperative endeavor (i.e., the excess of operating revenues over the costs incurred in generating those revenues), in proportion to the worker-members' active participation in the cooperative endeavor. [44 T.C. at 308]

It was not until 1972 with the publication of Revenue Ruling 72-36, 1972-1 C.B. 151, that the Service published a Ruling setting forth certain basic cooperative characteristics that an organization must have in order to receive a favorable ruling of exemption. For this reason it is an important Revenue Ruling.

Revenue Ruling 72-36 provides as follows:

- 1.) the rights and interests of members in the organization's savings must be determined in proportion to their business with the organization;
- 2.) excess funds remaining at the year's end may be retained in excess of those needed to meet current losses and expenses for such purposes as retiring indebtedness incurred in acquiring assets, expanding its services and maintaining reserves for necessary purposes, but such funds may not be accumulated beyond the reasonable needs of the organization's business;
- 3.) the organization must keep such records as are necessary to determine at any time each member's right and interest in its assets;
- 4.) a member's rights and interest may not be forfeited upon withdrawal or termination of membership; and
- 5.) upon dissolution, gains from the sale of appreciated assets should be distributed to all persons who were members during the period which the asset was owned by the organization in proportion to the amount of business done by those members during that period insofar as is practicable.

Thus, to qualify for recognition of exemption, a cooperative must have as its members persons or other organizations that are its customers; it must be owned and controlled by those members; and all annual earnings or savings must be returned to the members on the basis of the amount of business done by the members with the cooperative during the year. An actual distribution is not required at the end of each year where the excess funds are needed as explained in the Revenue Ruling; but the cooperative must keep such records as are needed to determine at any time each member's rights and interest in such retained funds including assets acquired with such funds.

It is not essential that a cooperative issue patronage certificates informing each member of his amount in the retained earnings, provided it keeps the records

described above. There are some very small cooperatives which can estimate their expenses in a way that will result in a small amount of net earnings being left over at the end of the year, all of which they will need to retain for the purposes explained in the Revenue Ruling. The issuance of patronage certificates by those organizations is impracticable. Actually a distribution by those cooperatives in the foreseeable future, if ever, may not be contemplated, but, if the amounts retained are reasonable, they may qualify for recognition of exemption provided they keep the records required by Rev. Rul. 72-36. They must be permanent records showing the organization's annual net earnings and the amount of annual business done by each member.

Many cooperatives actually issue patronage certificates and this is proper, provided the amount of the members' rights and interests as disclosed by the certificates is based on the amount of business done by the members. There are many reasons why this practice may be desirable and while it is not essential in order to meet the requirements for exemption, it will help to insure compliance with the provisions of IRC 501(c)(12). By issuing patronage certificates on a revolving fund basis, a cooperative is continually redeeming such certificates and this practice will assist in preventing an unreasonable accumulation of retained earnings which could jeopardize exemption. Also, if a cooperative's exemption is revoked, it may obtain the tax advantages for nonexempt cooperatives and exclude certain allocated amounts from its income in determining its corporate tax liability. See Revenue Ruling 59-322, 1959-2 C.B. 154, Reg. 1.61-5, and Subchapter T of the Code.

As Revenue Ruling 72-36 states, funds in excess of those needed to meet current losses and expenses may be retained for certain purposes, but they may not be accumulated beyond the reasonable needs of the cooperative's operation in furnishing electric energy or any other kind of service covered by IRC 501(c)(12). There is no clear-cut definite limitation that can be applied to every cooperative in determining the amount of accumulated margins that are reasonable. The issue in each case is whether the amount of retained funds, including cash and investments, responds to the needs of the cooperative or represents merely a device to retain money instead of making patronage refunds or otherwise in some acceptable way disposing of funds it would be "unreasonable" to retain. This limitation does not apply only to established reserves because an organization may accumulate margins in excess of its reasonable needs without establishing a definitive reserve fund. However, it should be noted that depreciation reserves are not considered excess amounts held to meet future losses and expenses because they are

established as part of actual operating costs and are not reserves created out of surplus.

As previously stated, all members must share in the earnings and savings, but nonmembers need not. If they are permitted to do so, however, it would not preclude recognition of exemption. See Revenue Ruling 70-130, 1970-1 C.B. 133, which held that IRC 501(c)(12) does not require members and nonmembers to be treated alike. Because of the 85 percent requirement which will be discussed later, the nonmember business done by an exempt cooperative must be relatively very small in amount. Moreover, because substantially all income must come from members, the earnings shared in by members will be derived from their payments to the cooperative except for the relatively small amount of nonmember income that an exempt cooperative can earn, including interest income and any income from providing services to nonmembers. In this connection it should be emphasized that all earnings, not merely earnings derived from furnishing services to members, must be distributed to the members on the basis of the amount of business that they have done with the cooperative. This requirement is reflected in question and answer No. 1 of Revenue Ruling 72-36 which states that the members have an interest in all the savings of the cooperative.

Upon dissolution, all remaining assets after the payment of debts should be distributed to members and former members on the basis of their patronage while they were members as disclosed by its records, insofar as is practicable. This requirement is implicit in the answers to the first four questions of Rev. Rul. 72-36. In this connection, it should be noted that the answer to question No. 5 of Rev. Rul. 72-36 merely states how gains from the sale of appreciated assets should be distributed upon dissolution.

The Service has reaffirmed the need to comply with basic cooperative principles in order to qualify for exemption in Rev. Rul. 78-238, 1978-1 C.B. 161. In this revenue ruling, the Service announced that it would not follow the Ninth Circuit's decision entered in Peninsula Light Co., Inc. v. United States, 552 F.2d 878 (9th Cir. 1977). This decision recognized exemption of an electric cooperative that did not provide for the distribution of its savings on a patronage basis, whose charter provided that members would forfeit their rights and interests in the organization upon termination of membership, and whose assets upon dissolution would be distributed to then current members, on a per capita basis. It is the Service's view that this method of operation is in conflict with cooperative principles and, therefore, the type of organization described in the Peninsula Light decision does not qualify as an exempt cooperative under IRC 501(c)(12).

Another important requirement that must be met is loosely referred to as the "85 percent member income" requirement. This requirement means, as the statute states, that 85 percent or more of the income must consist of amounts collected from members for the sole purpose of meeting losses and expenses. Compliance with the requirement is determined on an annual basis and it is a gross income test. Thus, each year a cooperative's total gross income is determined and the total amount collected from members must be at least 85 percent of the total gross income figure. If an organization uses the accrual method of accounting, compliance with the 85 percent test must be determined pursuant to that method. See Revenue Ruling 68-18, 1968-1 C. B. 271.

The difference between gross income and gross receipts is provided by IRC 62. This section provides that certain deductions may be made from gross receipts in arriving at gross income. For purposes of this general discussion, the only deductible amount would be the "cost of goods sold." For example, in the case of electric cooperatives, the National Office is considering what items are included in the "cost of goods sold" that is deductible from gross receipts derived from the sale of electricity generated by a cooperative.

The 85 percent income test is a simple one, but two important considerations have to be kept in mind. First, all gross income items must be included in determining compliance with this test. Interest income, dividends, and gains from the sale of capital assets, for example, must be included as income not collected from members to meet losses and expenses. It has been held that gain from the sale of an asset must be included even if the sale is an involuntary one. The Mountain Water Co. of La Crescenta v. Commissioner, 35 T.C. 418 (1960). Revenue Ruling 65-99, 1965-1 C. B. 242, concerned an exempt cooperative that sold an office building under a valid installment sale transaction as described in IRC 453 of the Code from which it realized a long-term capital gain. The cooperative received a down payment in the year of sale of 30 percent of the selling price and the balance in two equal installments in the two following years. The Revenue Ruling held that since the organization elected to report the transaction on the installment method, the amount to be taken into consideration for the purpose of the 85 percent requirement was the income portion of each installment payment actually received during a particular year or accounting period.

If an organization receives income from a member other than for purposes of meeting losses and expenses, that is, other than in payment for the services furnished by the cooperative, such income would not constitute "member income."

An illustration of this is where a cooperative has a net gain on the sale of an asset to a member. The gain would not be income received from a member for the sole purpose of meeting losses and expenses.

The second important thing to remember regarding the 85 percent test is that if a cooperative owes any payments to a nonmember, it cannot offset such amounts against any payments owed it by the nonmember in calculating the amount of gross nonmember income.

This principle is clearly illustrated by Revenue Ruling 65-174, 1965-2 C.B. 169. That Ruling concerned an exempt electric cooperative that built a generating unit to produce additional electric power that it anticipated it would need. It entered into a long term leasing-operating agreement with a nonmember company. Under the terms of the agreement, the company operated the unit from its own plant and paid the cooperative an agreed upon amount of rent. The agreement further provided that the company would sell the cooperative electric power it needed. At the end of the year the money which each party received from the other was set off against the money it paid with any difference being entered into its costs of generation as a plus or minus figure, increasing or decreasing its cost of producing power. The cooperative contended that the money received did not enter the income accounts of the parties. The Revenue Ruling held that this procedure was improper and that for purposes of determining compliance with the 85 percent income requirement, it had to include the full amount of the annual rental income paid to it under the contractual agreement as nonmember income.

Frequently, cases involving this principle are much more complicated than the one described in Revenue Ruling 65-174. In some of these cases it is difficult to determine precisely how much one party owes the other. In other cases, a question arises as to whether amounts received actually constitute income or whether the cooperative is merely a conduit with respect to the receipts in question. One ruling involving a telephone cooperative's receipt of income from a nonmember telephone company for the performance of long distance services is Revenue Ruling 74-362, 1974-2 C.B. 170. Although the effect of this revenue ruling was modified by statutory amendment (for tax years beginning after December 31, 1974, income from a nonmember telephone company for the performance of long distance services is excluded from the 85 percent member-income computation), the principle it announced remains viable. This principle is that insofar as the 85 percent test is concerned "there is no authority justifying the use of a method of accounting which sanctions the practice of offsetting continuing

items of income against related items of expense with the consequence that the cooperative's gross income is never fully reflected on its books."

3. Unrelated Business Income Tax Issues

a. General

Prior to enactment of the Tax Reform Act of 1969, the unrelated business income tax provisions did not apply to IRC 501(c)(12). Nevertheless, the 1969 Act provided that the UBIT provisions would apply to IRC 501(c)(12) organizations. There was no specific reason for having them apply to IRC 501(c)(12), and how and to what extent they apply must be determined on a case-by-case basis.

In analyzing the following material regarding the applicability of the unrelated business income tax provisions to cooperatives exempt under IRC 501(c)(12), one should be aware of two important considerations regarding the characteristics of exempt cooperatives. First, an IRC 501(c)(12) organization is by its nature engaged in providing a business type of service, although it does so on a cooperative basis. This characteristic creates conceptual difficulties in distinguishing between related and unrelated business activities of an exempt cooperative. Second, if 85 percent of a cooperative's gross income must be collected from members for the sole purpose of meeting losses and expenses, a question arises as to whether income received from an unrelated trade or business would constitute income from members for such purposes. If it would not, substantial amounts of income from an unrelated trade or business could cause a cooperative to fail the 85 percent member-income test.

b. Code and Regulations

IRC 511(a) imposes a tax on the unrelated business taxable income (as defined in IRC 512) of organizations exempt from federal income tax under IRC 501(c)(12). IRC 512(a) defines "unrelated business taxable income" as income from any "unrelated trade or business" regularly carried on by an organization computed in accord with the modifications provided by IRC 512.

Reg. 1.513-1(b) states that the primary objective of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete. Any activity of an IRC 511 organization which is carried on for the production of income and which

otherwise possesses the characteristics required to constitute "trade or business" within the meaning of IRC 162 and which, in addition, is not substantially related to the performance of exempt functions, presents sufficient likelihood of unfair competition to be within the policy of the tax.

Reg. 1.513-1(d)(1) provides that gross income derives from "unrelated trade or business" within the meaning of IRC 513(a), if the conduct of the trade or business which produces the income is not substantially related (other than through the production of funds) to the purposes for which exemption is granted. The presence of this requirement necessitates an examination of the relationship between the business activities which generate the particular income in question - the activities, that is, of producing or distributing the goods or performing the services involved - and the accomplishment of the organization's exempt purposes.

Reg. 1.513-1(d)(2) states that trade or business is "related" to exempt purposes, in the relevant sense, only where the conduct of the business activities has causal relationship to the achievement of exempt purposes (other than through the production of income); and it is "substantially related" for purposes of IRC 513 only if the causal relationship is a substantial one. Thus, for the conduct of trade or business from which a particular type of gross income is derived to be substantially related to purposes for which exemption is granted, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes.

Reg. 1.513-1(d)(3) provides that in determining whether activities contribute importantly to the accomplishment of an exempt purpose, the size and extent of the activities involved must be considered in relation to the nature and extent of the exempt function they purport to serve.

c. Sale of Appliances by Elective Cooperatives

The consideration of UBIT issues in connection with the activities of exempt cooperatives has not been extensive, but one area that is receiving attention is the sale of appliances by electric cooperatives. In Rev. Rul. 67-265, 1967-2 C.B. 205, it was stated that a cooperative organization furnishing heat and light to its members is a "like organization" and therefore exempt under IRC 501(c)(12). On the other hand, Rev. Rul. 65-201, 1965-2 C.B. 170, held that a cooperative engaged in selling electrical supplies and equipment does not qualify for exemption because it is not a "like organization." This latter revenue ruling suggests that the sale of appliances may not be considered as substantially related

to the accomplishment of the exempt purposes of a cooperative described in IRC 501(c)(12).

Let us review some pertinent considerations regarding this issue. In order for the sale of electrical appliances to be considered "substantially related," such sales must contribute importantly to the accomplishment of exempt purposes. Where a member purchases electricity from a cooperative for his personal use, does it follow that sale of appliances contributes importantly to the furnishing of electricity?

Certainly, it can be argued that by selling appliances a cooperative will increase energy use thereby furthering its exempt purpose, i.e., the furnishing of electricity.

The paramount question remains whether the sale of appliances bears a substantial causal relationship to the accomplishment of an electric cooperative's exempt purposes. In this regard, increasing energy use by the sale of appliances may not be regarded as sufficient to characterize such an activity as related within the meaning of Reg. 1.513-1(d)(2). Moreover, the general purpose of the UBIT provisions, as interpreted by Reg. 1.513-1(b), was to eliminate unfair competition that might arise between exempt organizations and ordinary businesses. There is no doubt that the sale of appliances such as TVs, radios, toasters, air conditioners, lighting products, microwave ovens, etc., by an exempt cooperative would compete with commercial retail enterprises in the marketplace.

As of this writing, the foregoing issue is under consideration by the National Office and a final resolution has not yet been reached. In addition, one should be aware that exempt electric and telephone cooperatives are expanding into other services, which will likely raise UBIT questions. The National Office has become aware of two such areas, namely, computer services and cable television.

d. Pole Rentals

The treatment of income from utility pole rentals under UBIT provisions is a question that has been recently addressed by the National Office. This issue has arisen in connection with exempt electric cooperatives, but could also apply to telephone cooperatives.

At least in the case of electric cooperatives, space on the utility poles owned by the cooperative is leased to other companies, frequently on a reciprocal basis.

Several reasons have been cited for this practice. Among them are the elimination of unnecessary costs, protection of the environment, and easier maintenance. Because such a leasing arrangement provides an economy to lessees, it would appear that this activity is not substantially related to the accomplishment of one or more of a cooperative's exempt purposes. This is the principal argument in support of the conclusion that rental income derived from the leasing of space on utility poles is subject to the unrelated business income tax under IRC 511.

A recent technical advice memorandum (IRS Letter Ruling Reports, Ltr #7828001, March 13, 1978) issued by the National Office dealt with whether income received by an IRC 501(c)(12) electric cooperative from leasing space on its utility poles constituted UBIT. Pertinent parts of that memorandum, which concluded that such income is subject to tax under IRC 511, are reproduced below:

LTR 7828001, March 13, 1978

Symbol: E:EO:T

NATIONAL OFFICE TECHNICAL
ADVICE MEMORANDUM

[Code Sec. 512]

Exempt organizations; Unrelated business taxable income;
Leasing by electrical cooperative of space on utility poles.--CCH.

ISSUE

Whether income received by a section 501(c)(12) electric cooperative from the leasing of space on its utility poles is subject to unrelated business income tax under section 511 of the Code.

FACTS

The cooperative is recognized as exempt from Federal income tax under section 501(c)(12) of the Code for the purposes of generating, purchasing, and supplying electric energy.

The cooperative allows fifteen telephone, electric, and cable television companies to attach their lines to the cooperative's utility poles on a lease basis.

The cooperative has financed the construction of its utility lines through loans from the Rural Electrification Administration (R.E.A.) of the U. S. Department of Agriculture. The R.E.A. thus has an interest in seeing that its debtor-cooperatives operate in a sound fashion and at as low a cost as possible.

Accordingly, the R.E.A. encourages the joint use of utility poles wherever feasible and has developed model agreements for the debtor-cooperatives' use. The cooperative uses the R.E.A. models for its joint use agreements and has furnished us with copies of agreements entered into with various organizations.

A typical agreement, utilizing R.E.A. Form 777, provides that the licensee, in this case the telephone company, shall furnish descriptions and specifications concerning pole line changes necessary for joint use to the owner of the pole line, in this case the cooperative. The cooperative then estimates the cost of the changes and, after approval by the licensee, proceeds with the modifications. Upon completion of all changes, the licensee shall pay the cooperative the actual cost (including overhead and less salvage value of materials) of making the changes but in no event, however, shall the licensee be required to pay more than 120% of the cost estimate. Any reclearing of existing rights-of-way and any tree trimming necessary for the establishment of joint use is to be performed by the parties according to agreement. The cost of the reclearing is to be shared.

Article IV of the contract states that, while the cooperative will cooperate as far as may be practicable in obtaining rights-of-way for joint use, it does not warrant or assure to the licensee any right-of-way privileges or easements, and if the licensee is at any time prevented from placing or maintaining its attachments on the cooperative's poles, the cooperative shall not be liable. It further provides that each party shall be responsible for obtaining its own easements and rights-of-way.

The contract provides for an annual rental fee calculated in a mutually agreed manner and adjustable every five years.

In "Discussion of Agreement for Joint Use of Electric System Poles -- R.E.A. Form 777," which was attached to the sample contract, the R.E.A. suggests various factors to be taken into account in calculating the amount of the fee including the cost of poles in place, right-of-way clearing and reclearing, labor, and materials. The R.E.A. further states that in any leasing arrangement which is advantageous to both parties, it is usual practice to share

the benefits or savings. The major share of the savings should accrue to the cooperative because of its responsibility to maintain the pole line after joint use is established. The R.E.A. suggests that, as a guide, 70% of the savings accrue to the cooperative and the balance to the licensee. The annual rental paid by the licensee to the cooperative then equals 70% of the savings as determined by the agreement.

LAW

Section 511 of the Code imposes a tax on the unrelated business taxable income of organizations otherwise exempt from Federal income tax under section 501(c)(12) of the Code.

Section 512(a)(1) of the Code defines "unrelated business taxable income" as the gross income derived from any unrelated trade or business regularly carried on, less those deductions allowed by Chapter 1 of the Code which are directly connected with the carrying on of such trade.

Section 512(b)(3)(A) of the Code excludes from the computation of unrelated business taxable income all rents from real property (including property described in section 1245(a)(3)(c)), and all rents from personal property (including for purposes of this paragraph as personal property any property described in section 1245(a)(3)(B)) leased with such real property, if the rents attributable to such personal property are an incidental amount of the total rents received or accrued under the lease, determined at the time the personal property is placed in service.

Section 512(b)(3)(B) of the Code states that subparagraph (A) shall not apply if more than 50 percent of the total rent received or accrued under the lease is attributable to personal property described in subparagraph (A).

Section 513 of the Code states that "unrelated trade or business" means, in the case of an organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of the profits derived) to the exercise or performance of its exempt purpose.

Section 1245(a)(3)(B) of the Code refers to tangible property, other than personal property, subject to the allowance for depreciation provided in section 167 (or subject to the allowance for amortization provided in section 185) but only if the property

has an adjusted basis in which there are reflected adjustments described in section 1245(a)(2)(A) during which it was used as an integral part of furnishing transportation, communications, electrical energy, etc.

The adjustments described in section 1245(a)(2)(A) mean the adjusted basis recomputed by adding thereto all adjustments attributable to periods after December 31, 1961. These adjustments must be reflected on account of deductions allowed or allowable for depreciation or amortization. See section 1.1245-2(a)(2) of the regulations.

Section 1.512(b)-1(c)(2)(ii) of the Income Tax Regulations provides that an "incidental amount" is defined as 10 percent or less of the total rents from all the property leased.

Section 1.513-1(b) of the regulations states that for purposes of section 513 the term "trade or business" has the same meaning it has in section 162, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. Where an activity carried on for the production of income constitutes an unrelated trade or business, no part of such trade or business shall be excluded from such classification merely because it does not result in profit.

Section 1.513-1(d)(2) of the regulations states that a trade or business is "related" to exempt purposes only where the conduct of the business activity has a causal relationship to the achievement of exempt purposes. In addition, the causal relationship must be a substantial one.

Section 1.1245-3(c) of the regulations defines "section 1245(a)(3)(B) property" as tangible personal property of the requisite depreciable character other than personal property, but only if there are adjustments reflected in the adjusted basis of the property for a period during which such property was used as an integral part of furnishing communications or electrical energy as defined in section 1.48-1(a) of the regulations.

Section 1.48-1(a) of the regulations provides that, with exceptions not relevant here, the term "section 38 property" means property (1) with respect to which depreciation is allowable, (2) which has an estimated useful life of 3 years or more, and (3) which is either (i) tangible personal property or (ii) other tangible property but only if such other property is used as an integral part of furnishing communications or electrical energy.

Section 1.48-1(d)(4) of the regulations lists "telephone poles" as an "integral part" of the furnishing of communications.

Revenue Ruling 67-218, 1967-2 C.B. 213, states that income derived from a lease of a pipeline system, consisting of right-of-way interests in land, pipelines buried in the ground, pumping stations, plants, equipment, and other appurtenant properties, constitutes rent from real property (including personal property leased with the real property) within the meaning of section 512(b)(3) of the Code.

Revenue Ruling 75-135, 1975-1 C.B. 56, states that the maintenance costs of tree trimming and brush clearing from easements for the transmission and distribution of electrical energy are deductible operating expenses and are not part of repair allowance for the Electrical Transmission and Distributing Facilities, asset guideline class 49.14.

RATIONALE

The purpose of the cooperative for which exemption was recognized is to provide electric energy to its members. Although it may be empowered to undertake other, incidental, activities by its organizing document, by action of law, or through governmental encouragement, those additional activities are not the purpose for which exemption was recognized and any income generated by them may or may not be exempt from Federal income tax under the Internal Revenue Code.

Section 511 through 513 of the Code provide for the taxation of income derived from the additional activities if they constitute a trade or business regularly carried on and they do not have a substantial causal relationship so the achievement of the exempt purpose of the cooperative.

The cooperative maintains that the leasing of space on its utility poles does not constitute a trade or business because it is not an activity carried on for the production of income from the sale of goods or the performance of services. Rather, the leasing is a mere cooperative and mutual transaction permitting both parties to avoid incurring certain costs associated with alternative means of achieving the same goal. The cooperative maintains that the rental fee is calculated to produce only an incremental amount of income that might be equated to the actual costs of making and maintaining the attachment.

However, the information submitted indicates that the fee is actually determined by taking a percentage of the lessee's savings as a result of not having to construct its own pole line. The fee is thus not based on the expenses actually incurred by the cooperative in leasing the space. Although the cooperative's records do not match the expenses incurred in the leasing with the revenues obtained, the method of computation of the fee is such that it is highly probable that the cooperative has income in excess of its expenses in the pole leasing activity viewed as a unit separate from the cooperative's other activities in the absence of evidence to the contrary.

Accordingly, whether the cooperative derives net income from the leasing arrangement varies from case to case but the cooperative always receives gross income. The questions then become those of determining whether the income is from a related trade or business, and, if not, whether all or part of the income is excluded from the computation of unrelated business taxable income by reason of the modifications of section 512.

The cooperative argues that the leasing of space on its utility poles is related to the provision of electric energy to its members because the telephone system using the poles permits quicker notification of power outages and otherwise expedites the administration of the electric system.

In support of its position, the cooperative has submitted affidavits from various individuals with expertise in the area of telephone and electric cooperatives. The affidavits maintain that having telephone service in the same areas served by the electric cooperative greatly increases the level of the quality, dependability, and safety of an electric cooperative's operations. In addition, joint use reduces the cost of both electric and telephone service by avoiding duplication of facilities.

We have given lengthy and careful consideration to the views expressed in the submissions. We agree that communication with member-customers is related to providing them with electric energy. However, section 513 of the Code and section 1.513-1(d)(2) of the regulations require that the activity have a substantial causal relationship to the exempt purpose or function. The facts submitted by the cooperative only support a finding of general benefit arising from modern communications. Similar benefits accrue to all forms of enterprise through telephone service. Section 513 and the accompanying regulations require a greater nexus with

the exempt purpose, however, as the requisite relationship must be a substantial causal one.

While the information submitted establishes a relationship between the joint use of telephone poles with a telephone company and the transmission of electric energy, the primary purpose of such joint use, based on the method of calculating the rental fee, is to achieve an overall reduction in the costs incurred by both parties in carrying out their respective purposes. The fact that the electric cooperative obtains a benefit from the presence of a communications network in addition to the rental fee is incidental to the primary purpose of generating income to reduce expenses. Under section 513, the use made of the income from an otherwise unrelated trade or business is insufficient to establish the necessary substantial causal relationship. Moreover, the mere fact that a telephone company or some other organization using the cooperative's poles is a member would not in itself establish such a substantial causal relationship. There is no substantial causal relationship between furnishing a member telephone cooperative with electricity and leasing pole space to it.

The fact that space is leased to organizations other than telephone companies lends support to the conclusion that the primary purpose of the leasing activity is the generation of income. The communications benefit provided by the telephone company is not present when the lessee is a cable television concern or another electric company.

The cooperative maintains that it is not subject to unrelated business income tax on the income because it is not competing with any for-profit organizations in leasing the space. The Code and the regulations, sections 511 to 513, do not, however, require a finding of unfair competition, but rather, a determination that the activity in question constitutes a trade or business regularly carried on that is unrelated to the exempt purpose of the organization in question. The effect of the activity on third parties is neither dispositive nor persuasive for purposes of the unrelated business income tax.

Once a determination has been made that an activity constitutes an unrelated trade or business regularly carried on, then a further determination must be made under the modifications of section 512 with regard to whether any of the income is excluded from the computation of unrelated business taxable income.

Before the Tax Reform Act of 1969, section 512(b)(3) of the Code simply excluded all rents from real property and personal property leased with the real property from the computation of unrelated business taxable income. The Code did not define real property or personal property as used in section 512; however, Revenue Ruling 67-218 was issued which utilized common law definitions.

The Tax Reform Act of 1969 modified section 512(b) by incorporating the definitional sections of section 1245 and by providing for the exclusion only if the rents attributable to the personal property leased with real property are an incidental amount of the total rents received or accrued under the lease. Now, section 512(b)(3)(A)(ii) defines personal property as including any tangible property described in section 1245(a)(3)(B).

Section 1245(a)(3)(B) and the regulations issued under that section refer, for definitional purposes, to section 1.48-1(a) of the regulations. In turn, the definitional paragraph for that section cites telephone poles as an example of the type of tangible property involved. Although section 1245(a)(3)(B) and the accompanying regulations contain requirements involving depreciation and amortization, these restrictions have relevance only for organizations that have filed income tax returns. It is clear from the example provided in the definitional paragraph that, solely for purposes of unrelated business income tax, utility poles are to be considered tangible property treated as personal property.

Therefore, under section 512, an allocation must be made between the rental income attributable to real property and the income attributable to personal property. At the National Office conference, the cooperative was apprised of the necessity for the breakdown and allocation regarding real and personal property in the event that the income was considered unrelated business income and was asked to submit the data.

While the use of a pole line right-of-way is not guaranteed under the terms of the sample R.E.A. contract, Form 777, an alternative sample contract, Form 263, indicates that the cost of an easement may be taken into account in determining the amount of the annual rent. Also, Form 777 indicates that right-of-way clearing and reclearing are some of the factors that may be taken into account in determining the amount of the annual rent. However, in accordance with Revenue Ruling 75-135, income derived from right-of-way reclearing would not be income attributable to real property because maintenance costs for power

line easements are considered operating expenses when incurred by taxable electric utilities.

In a brief submitted by the cooperative, it maintains that the joint use agreements are fundamentally dependent upon its ownership interests in real property, primarily the rights-of-way easement. According to this line of reasoning, the income from the pole rental agreement is derived, at least in part, from a real property interest and thus should be excluded from the computation of unrelated business income tax under the modifications of section 512.

However, while the cost of easements and initial right-of-way clearing may have been factors taken into consideration in arriving at the amount of the rental fees charged, the contracts furnished by the cooperative do not show to what extent they were taken into account or that they were considered at all. Moreover, the cooperative has not shown the actual method and percentages utilized in any of its submissions. The percentages of income attributable to real property and to personal property (including section 1245(a)(3)(B) property) must be shown in order to apply the modifications under section 512.

In the absence of such a breakdown and allocation, we cannot conclude that at least 50 percent of the annual income from the pole rental is attributable to real property and thus excluded from the determination of unrelated business taxable income by the modifications of section 512.

The request for technical advice raised the question of the possible applicability of section 514 concerning unrelated debt-financed income. Inasmuch as the entire amount of the rental fee is taxable as unrelated business income, section 514 would not apply as section 514(b)(1)(B) excludes from consideration as debt-financed property any property to the extent that its income is already subject to tax as income from the conduct of an unrelated trade or business.

CONCLUSION

Accordingly, based on the foregoing, we conclude that the income received by the cooperative from the leasing of space on its utility poles is subject to unrelated business income tax computed with the appropriate deductions.

As the foregoing memorandum makes clear, lease income from the rental of space on utility poles is subject to the unrelated business income tax. Moreover, this would be the case even though the use of utility poles between cooperatives was on a reciprocal basis. In addition, as indicated in the case above, where a cooperative is unable to show that 50 percent of the pole rental income is attributable to real property, such income would not be excluded from the determination of unrelated business taxable income by the modifications of IRC 512. The conclusion set forth in the disclosed technical advice memorandum remains unpublished; however, publication of this position is being considered.

4. Recent Legislative Developments

Currently, there are four bills pending in the 96th Congress which relate to electric and telephone cooperatives described in IRC 501(c)(12). They are S. 1069, H.R. 3521, H.R. 4432, and H.R. 5643. Generally, these bills propose changes to the 85 percent test of IRC 501(c)(12) and the computation of unrelated business taxable income under IRC 512.

With regard to the IRC 501(c)(12) exemption provision itself, the proposed legislation would provide that any income obtained by an electric cooperative from nonmember electric companies will be taken into account for purposes of the 85 percent test only to the extent that the aggregate amount of such income exceeds the aggregate amount paid or incurred by the electric cooperative to nonmember electric companies for electric energy. A further change to IRC 501(c)(12) would also provide that any income received by an electric cooperative from providing (pursuant to an order of any agency or instrumentality of the United States or of any State) electric energy to a nonmember electric company would not be taken into account for purposes of the 85 percent test.

With regard to IRC 512, the proposed legislation would exclude from the computation of unrelated business taxable income of electric and telephone cooperatives (1) all income collected from members for services customarily provided by rural telephone companies (or electric companies) to their customers, and (2) all income derived from the rental or sale of communications or power facilities or space to a person for use in furnishing telephone (or other communication services) or electric energy. This part of the proposed legislation is apparently directed, in part, to the Service's position that was set forth in the technical advice memorandum discussed above.

As far as the status of this proposed legislation is concerned, S. 1069 has been referred to the Senate Finance Committee and no action has been taken. The bills introduced in the House, H.R. 3521, H.R. 4432, and H.R. 5643, have been referred to the house Ways and Means Committee. No action has been taken with respect to these bills either.